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THE PRESENT tax treatment of bad-debt reserves afforded savings and loan associations is currently subjected to increased congressional pressures from within and without the Kennedy Administration. Here is a description of the mechanics of 1954 Internal Revenue Code governing these reserves as now constituted.

In 1951, Congress removed the blanket tax exemption that it had previously granted to savings and loan associations. To mitigate the effect of the loss of exemption, it appears to have been congressional intent to substitute certain statutory deductions that because of their liberality tend to decelerate the sudden change from tax-exempt to taxpayer. Among these liberalized deductions, not available to other corporate taxpayers, are the deduction for dividends paid on deposits (IRC Sect. 591); the deduction for repayment of certain loans (IRC Sec. 592); and most important—the deduction for additions to the Reserve for Bad Debts (IRC Sec. 593) which allows many associations to offset all of their taxable income.

In a sense, ten years from 1951 to 1961 have been to the savings and loan association taxpayer what the ten years from 1913 to 1923 were to other taxpayers. In these ten years, the Commissioner of Internal Revenue has issued rulings interpreting the Code and Regulations and the Courts have arbitrated sporadic disputes between the Commissioner and taxpayers who disliked the Commissioner's interpretations. The result of all of this is a liberalized bad-debt deduction subject to certain rules and technicalities over which the Commissioner presides with unyielding exactness, ever wary of any breach of these rules or technicalities.

ELECTION

Like all taxpayers, savings and loan associations may elect either the direct charge-off method[1] of deducting bad debts as they become worthless or the reserve method which allows a tax deduction for a reasonable addition to the reserve. Election of the direct charge-off

[1] IRC Sec. 166(a).

method is rarely if ever made as, unlike other taxpayers, the addition to the reserve by savings and loan associations may not be less than the amount *determined by the taxpayer* as the reasonable addition subject to the limitations later described. Here then is one instance where a taxpayer may establish a deduction without exhibiting experience and no one may challenge him. The savings and loan association must make its election in its return for the first taxable year after December 31, 1951 in which actual bad debts were sustained.[2]

LIMITATIONS—12 PER CENT FORMULA

The addition to the Reserve for Bad Debts may not exceed the lesser of (i) taxable income before the bad-debt deduction (and without regard to any deduction dependent on the amount of taxable income such as contributions and the 85 per cent dividends-received deductions[3]) or (ii) the amount by which 12 per cent of the total of the association's deposits at the end of the taxable year exceeds the total of its surplus, undivided profits, and loss reserves at the beginning of such year.

Deposits at the end of the taxable year include shareholders' dividends credited before the close of the taxable year[4] (even if not withdrawable until the next taxable year) and mortgagors' tax and insurance escrow accounts.[5] It should be noted that in determining the deduction for dividends paid on deposits, dividends must be both credited and withdrawable during the year of deduction. The coupling effect of Sections 591 and 593 allows a deduction of 112 per cent of the amount of dividend credited.

Surplus, undivided profits, and loss reserves include (i) Federal Insurance Reserve, (ii) Reserve for Bad Debts, Reserve for Losses, Special Reserve for Bad Debts, (iii) Reserve for Contingencies.[6]

If 12 per cent of deposits does not exceed surplus and reserves, further additions to the Bad-Debt Reserve must be supported by bad-debt experience.[7] The courts have followed this doctrine even in cases where regulatory authorities required increases in a loss reserve such as to the Federal Insurance Reserve. In *Bellefontaine Federal Savings and Loan Association* 33 TC 808 (1960), required loss reserve additions were not allowable tax deductions as the 12 per cent limit had been

[2] Rev. Rul. 211, CB 1953-2, 21.
[3] Rev. Rul. 59-331, CB 1959-2, 157.
[4] Regs. 1.593-1(d)(3).
[5] Rev. Rul. 55-435, CB 1955-2, 540.
[6] Regs. 1.593-1(d)(2)(iii).
[7] Regs. 1.593-2.

reached and experience did not support the deduction. More recent cases have reaffirmed this position that regulatory agencies do not control the revenue laws.[8]

ACCOUNTING FOR THE BAD-DEBT RESERVE

The addition to the Bad-Debt Reserve must be placed on the books of the association as soon as practicable after the close of the taxable year[9] although the Bad-Debt Reserve does not have to appear on the association's published statements[10] and most frequently is grouped under the caption "Reserves and Surplus." The Commissioner has ruled that an entry to undivided profits is fatal even though Federal Regulatory Authorities would have allowed credit to a loss reserve instead.[11] In a recent Tax Court case, *Colorado County Federal Savings and Loan Association* 36 TC, No. 118 (1961), retroactive reserve additions were disallowed as tax deductions. Here, the association's books reflected as undivided profits the amount shown on the Federal income tax return as the addition to the Bad-Debt Reserve. A subsequent book transfer did not cure the defect.

However, subsequent transfers to the undivided profits account do not produce taxable income if made from pre-1951 additions to the Bad-Debt Reserve.

Although the deduction is characterized as an addition to the Bad-Debt Reserve, additions to other loss reserves qualify. The Regulations state that amounts credited in compliance with Federal Regulations or State Statutes to accounts against which charges may be made for the purpose of absorbing losses will be deemed to have been credited to the Bad-Debt Reserve.[12] Some doubt has been cast on the Reserve for Contingencies by the decision in *Rio Grande Building and Loan Association* 36 TC, No. 68 (1961) in which the court held, in this particular instance, that the taxpayer did not prove that this reserve was intended to be used as a bad-debt reserve. In the case of Federal savings and loan associations, tax accounting for the bad-debt reserve has an interplay with the Federal Regulations on Insurance of Accounts. For example, the so-called Special Reserve for Bad Debts, which would qualify for tax purposes, no longer qualifies for Federal

[8] *Southside Building & Loan Association v. Hooks,* 188 F. Supp 652 (1960).
[9] Regs. 1.593-1(c).
[10] Rev. Rul. 56-404, CB 1956-2, 326.
[11] Rev. Rul. 182 CB 1953-2, 120.
[12] Regs. 1.593-1(c).

Insurance Reserve carryover credits in meeting the insurance requirements of over 20-year old Federal associations.

Associations use the benefits to wipe out taxable income when it would otherwise exist. A case in point is the treatment of current expenditures that are not allowable as tax deductions (such as contributions in excess of 5 per cent of taxable income). These unallowable expenditures are charged to undivided profits on the books of the associations. This has the effect of increasing current year's income according to the books by the amount of the expenditure not allowable for tax purposes. The increase is then deducted along with the rest of the association's income for the year as an addition to the bad-debt reserve so that there is no taxable income for the year despite the presence of unallowable expenditures.

Associations that have not reached the 12 per cent limit may also attempt to extend the benefits of Section 593 to cure tax deficiencies arising from redeterminations of their taxable income by Internal Revenue agents. The Regulations[13] contain an example of a situation wherein the reserve addition is retroactively increased to take up income generated by a redetermination. As a safeguard to this position, associations use the so-called "open-end resolution" which transfers to the reserve all of the current taxable income plus any additional amount of taxable income later determined.

CLOUDS ON THE HORIZON

The legislation governing the savings and loan association taxpayer is facing severe pressure directed at making his liberal deduction much less liberal or in taking it away from him altogether. The pressure is apparent in the courts and in the Congress.

In the judicial arena, the United States Court of Claims[14] has held that the reserve is not equivalent to a tax-free birthright granted to associations so that in the case of a Section 337 liquidation, post-1951 reserve additions must be restored to taxable income.

The much darker cloud is emanating from Congress. In 1959, a bill was introduced to reduce the bad-debt addition to the amount by which 5 per cent of the total of the association's deposits at the end of the year exceed the surplus and reserves at the beginning of such year as contrasted with the present 12 per cent limit. Another bill would have limited the bad-debt addition to ½ of 1 per cent of the

[13] Regs. 1.593-1(e)—Example (2).
[14] *Citizens Federal Savings and Loan Association of Cleveland v. U. S.* (6/7/61).

association's conventional loans outstanding at the close of the taxable year subject to a maximum reserve limit of 5 per cent for all additions since 1947.

More currently, in 1961, Congress was asked to consider substantial revision in the taxation of savings and loan associations as a part of President Kennedy's tax-reform measures for that year. In commenting on the tax-reform measures affecting all taxpayers, Secretary of the Treasury Dillon said to the Committee in August 1961:

"The tentative decisions on these proposals recently announced by your Committee would involve a net revenue reduction of about $300 million. I would urge that your final consideration of this legislation provide an approximate balance in over-all revenue effect, preferably through the addition of further revenue raising measures implementing the President's recommendations on closing loopholes, including a possible revision of the special tax provisions relating to mutual savings banks and savings and loan associations, or if need be through a small reduction in the 8 per cent level of the investment credit, or perhaps through some combination of both."[15]

Whatever Congress decides to do in 1962 or future years savings and loan associations have had for the past ten years a most complex and provocative deduction.

[15] As quoted in United States Savings and Loan League *Membership Bulletin* of August 28, 1961.